No. 70-52

IN THE
Supreme Court of the United States

OCTOBER TERM, 1971

UNITED STATES OF AMERICA, *Petitioner*

v.

MISSISSIPPI CHEMICAL CORPORATION, ET AL.

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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BRIEF AMICI CURIAE

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QUESTION PRESENTED

In computing their taxable income for the years involved, are respondents entitled to deduct, as interest or as a business expense, the amounts in excess of the fair market value of Class "C" stock of the New Orleans Bank for Cooperatives which respondents were required to agree to pay for such stock during those years in order to be able to borrow from the New Orleans Bank?

INTEREST OF AMICI CURIAE

This brief amici curiae, presented in support of the respondents, is filed pursuant to written consent of the parties on behalf of Agway, Inc., a farmers' cooperative, and numerous local cooperatives affiliated with Agway, Inc. and also on behalf of M.F.A. Central Cooperative, which is also a farmers' cooperative. One of the local cooperatives in the Agway system is Penn Yan Agway Cooperative, Inc., in whose favor the United States Court of Claims has rendered a decision in a suit involving the identical question presented here (except for the fact that the suit concerned Class "C" stock of the Springfield, rather than the New Orleans, Bank for Cooperatives). *Penn Yan Agway Cooperative, Inc.* v. *United States,* 417 F.2d 1372 (1969). The United States Court of Appeals for the Eighth Circuit has rendered a decision against M.F.A. Central Cooperative in a case also involving the question presented here, but with respect to the Class "C" stock of the St. Louis Bank for Cooperatives. *M.F.A. Central Cooperative* v. *Bookwalter,* 427 F.2d 1341 (8th Cir. 1969), *rev'g.,* 286 F. Supp. 956 (E.D. Mo. 1968), petition for certiorari pending, No. 824, this Term.

STATEMENT OF THE CASE

The facts in this case are fully set forth in the briefs of the parties.

ARGUMENT

The court below, after reviewing all the relevant facts, concluded (1) that the district court was not clearly erroneous in finding as a fact that the fair market value of Class "C" stock of the New Orleans Bank for Cooperatives was not in excess of the nomi-

nal value of $1 per share, and (2) that the amounts in excess of such fair market value which respondents were required to pay in order to borrow from the Bank were, in reality, interest payments and were deductible as such. We shall first discuss the legal issue involved—i.e., the proper tax treatment of whatever amount in excess of fair market value of Class "C" stock the taxpayers purportedly paid for such stock. We shall then demonstrate the fallacy in the government's arguments that such stock had a fair market value equal or close to its par value.

A. Respondents Are Entitled To Deduct, Either as Interest or as Business Expense, the Amounts by Which Required Payments for Class "C" Stock Exceeded the Fair Market Value of Such Stock.

The fundamental issue in this case is the true nature of the payments which respondents were required to make, purportedly for Class "C" stock of the New Orleans Bank for Cooperatives, in order to be able to borrow money from that Bank—i.e., was the entire amount of such payments really for Class "C" stock, or was the excess over the fair market value of such stock in fact paid for the use of borrowed money?

Throughout the course of this litigation, the government has persistently refused or been unable to recognize this point and has instead apparently chosen to characterize the question as being one of whether or not the Class "C" stock is a capital asset.

We willingly concede that Class "C" stock itself is a capital asset. That fact, however, has nothing whatever to do with the outcome of this case. The question here is not the character of Class "C" stock as a capital or noncapital asset, but, rather, how much

of the $100 ostensibly paid for a share of Class "C" stock, was in fact paid for that stock and how much was paid for the use of borrowed money. The answer to this question must be based upon a determination of the fair market value of the Class "C" stock, which was found by the district court to be no more than $1 per share. To the extent that the total payment of $100 per share exceeded the fair market value of the stock, it was, in reality, a payment for the only other item which the borrower acquired namely the use of money. As such, it should be fully deductible, either as interest or as a business expense.[1] The principle governing this case is as simple and fundamental as any in the tax field. In whatever context the issue arises, it is clear beyond question that when the parties to a transaction involving the purchase or exchange of two or more items of property or services allocate the total price between the items on a basis which bears no relation to the true facts, the Revenue Service and the courts will reallocate the price on the basis of the true facts.

Thus, suppose A lends money to B at a 5% interest rate but that, as part of the loan transaction, A also requires B to buy from A for $100 a capital asset admittedly worth only $5. Is it not clear beyond doubt that the Revenue Service would require A to include

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[1] If, as a corollary, any equivalent amount must be included in the income of the Bank in years after the termination of its exempt status, the dire consequences predicted by the government (Govt. Br. p. 21, fn. 16) need not come to pass. This is so, because the Banks, if they comply with the provisions of Subchapter T of the Internal Revenue Code, which becomes applicable upon termination of their exempt status, can, through the payment of patronage refunds largely in the form of Class "C" stock, obtain an offsetting deduction.

in ordinary income, as interest, not only the 5% designated by the parties as interest, but also the $95 representing the excess of the price for the asset over its fair market value? The answer must be "Yes." Indeed, if A contended that the $95 should be treated as proceeds from the sale of a capital asset, the Service would not even give this contention respectful consideration. Is it not also obvious that if the excess $95 is interest received by A, it is also interest paid by B? Again, the answer must be "Yes," since interest received by the lender and interest paid by the borrower are but two sides of the same coin. These answers are merely one manifestation of the well-established principle that the substance, rather than the form, of a transaction controls its tax consequences. Its application here can only result in a determination that no more than a small fraction of the payment purportedly made for Class "C" stock should be allocable to the acquisition of such stock, and the bulk of the payment must be allocated to the use of borrowed money, which was the only other item acquired by the taxpayer.

The government relies upon language in the Farm Credit Act to show that Congress intended payments for Class "C" stock in Banks for Cooperatives to be capital contributions and nothing more. However, as the government itself recognizes, the language of a non-tax statute cannot control the tax consequences of transactions within its scope. Though the Farm Credit Act speaks of capital structure and investment, the statute can offer no help in characterizing, for tax purposes, the payments for Class "C" stock.

It is true that under the statutory scheme the capital furnished the Banks for Cooperatives by the govern-

ment and represented by Class "A" stock was to be replaced by funds derived from the cooperative users of the Banks, whether such funds were retained earnings represented by Class "C" stock issued as patronage refunds, or whether they were payments purportedly made for the required purchases of Class "C" stock. Thus, for corporate purposes, it might be said that such amounts were "capital" of the Banks. But the fact that such funds are devoted by the Bank to the replacement of government capital has no bearing on the proper income tax treatment of the transactions giving rise to such funds. The revolving fund mechanism does not presuppose that funds used to retire government capital are, themselves, capital. This is clear from the fact that the replacement of government capital and an increase in ownership and control by cooperatives is a result which obtains regardless of the value of Class "C" stock, regardless of how much of a cooperative's payment is allocated to an investment in stock and how much is allocated to a payment for the use of money, and regardless of the outcome of this case. Those amounts paid by borrowing cooperatives, purportedly for Class "C" stock but actually for the use of money, do not lose their character as interest (or business expense) merely because the Bank uses such amounts to retire government capital. Furthermore, a finding that the Class "C" stock has only nominal value is not inconsistent with the realization of the statutory plan for retirement of government stock. The fact that, pursuant to the statutory scheme, private funds were replacing government money in the Banks, has no bearing whatever upon the tax treatment to be accorded the payment of such private funds; and, to look at the other side of the coin, the fact that the

private dollars flowing into the Bank were, for tax purposes, interest payments rather than capital investments did not diminish the number of private dollars available to replace government capital.

The Court of Claims realized this in the *Penn Yan* case, *supra,* when it stated:

> "Of course, Congress considered the 15 percent surcharge on interest payable on loans as a means of providing capital to the banks for cooperatives, and the bank realistically and lawfully treated as capital, funds received in that manner. But *from the standpoint of plaintiff-taxpayer,* this was in reality an increase of the basic interest rate as an experienced cost of borrowing money from the bank, *even described in the statute and in the loan agreements as a percentage of interest payable on the loans.* Its expenditure of $407, at least in greater part, was in reality an item of cost of conducting its business, and in the absence of compelling law to the contrary, and to the extent that it was a reasonably ascertainable cost, should be offset against plaintiff's income in the taxable year involved, in accordance with the annual accounting principle of the federal income tax laws. This is true whether such ascertainable cost is deemed interest paid under § 163 or an ordinary and necessary business expense under § 162 of the Internal Revenue Code of 1954." (Emphasis supplied.)[2]

[2] There need be no fear that this appropriate application of the annual accounting principle will result in a tax windfall to respondents. The current deduction of the amounts in issue is fully justified by the fact that respondents actually expended those amounts in the years involved and received therefor nothing of value except the use of money. If and when the Class "C" stock here involved is redeemed by the Bank, respondents will clearly realize income to the extent of the amounts previously deducted.

That Congress itself in situations like the present one does not intend characterizations of transactions in non-tax statutes to control tax consequences is demonstrated by a controversy involving the Federal National Mortgage Association (FNMA). Under its governing statute, the FNMA required mortgage sellers to purchase FNMA stock at par, such payments being characterized by the statute as "capital contributions." The FNMA stock was issued at a par value of $100 per share, but had a market value of approximately 50% of par, and the tax treatment of the excess of the amount required to be paid for FNMA stock over the fair market value of such stock was the subject of dispute.[3] In order to resolve the doubts which had given rise to this controversy, Congress added Section 162(d) to the Internal Revenue Code (P.L. 86-779, 86th Cong., 2d Sess., Sept. 14, 1960, 1960-2 C.B. 709, 713) making it clear, despite the fact that the FNMA statute spoke of "capital" and "capital contributions," that Congress had not intended that statutory language to dictate the tax consequences concerning the excess of par value of FNMA stock over its fair market value. For taxable years beginning after 1959, Section 162(d) specifically provides for the deduction of such excess in the case of required purchases of FNMA stock by mortgage sellers. The Committee Reports explaining the reasons for such treatment state:

> "Taxpayer-subscribers generally have assumed that any excess of the issuance price over the

[3] Compare *Ancel Green & Co.*, 38 T.C. 125 (1962), *acq.* 1963-1 C.B. 4 (see Rev. Rul. 63-44, 1963-1 C.B. 11) with *McMillan Mortgage Co.*, 36 T.C. 924 (1961), *acq. in result only*, 1963-1 C.B. 4, both of which upheld the deductibility of such excess.

market price of this stock represented an ordinary and necessary expense incurred in carrying on their trade or business since they acquired the stock in order to sell their excess supply of mortgage paper. In 1958, however, the Internal Revenue Service ruled (Rev. Rul. 58-41, 1958-1 C.B. 86) that no part of the purchase price of stock of FNMA constituted a deductible business expense. Instead, it was held that the entire amount paid for the stock must be capitalized and treated as the cost of the stock so acquired. Thus, this ruling holds that there is no tax effect at the time of the purchase or issuance of the stock even though the market price of the stock then is substantially below the issuance price. Instead, the tax effect occurs only when the stock is sold by the taxpayer.

"Your committee believes that it is unfortunate to require the capitalization of these expenditures for FNMA stock by taxpayer-subscribers to the extent they represent the excess of purchase price over market price. *Viewed from such a taxpayer's standpoint, the excess appears clearly to be expenditures which he must incur in order to sell the mortgage paper he holds.* In view of this, your committee believes that such amounts should be treated as ordinary and necessary expenses incurred in carrying on a trade or business. This, of course, means that in the transaction which occurs when the stock is sold (usually a capital transaction) the basis of the stock should not include this amount previously taken as a deduction." (H.R. Rep. No. 1662, 86th Cong., 2d Sess. 3 (1960), 1960-2 C.B. 816, 818; S. Rep. No. 1767, 86th Cong., 2d Sess. 8 (1960), 1960-2 C.B. 829, 834.) (Emphasis supplied.)

The same lack of Congressional intention to control tax consequences should be attributed to the language employed in the Farm Credit Act.

The courts have consistently held that amounts which are in fact paid for the use of money constitute interest, though in form such amounts may appear to be something other than interest and though the parties may not have called them interest. In a case involving the usury laws, for example, the Court of Appeals stated:

> ". . . . The familiar doctrine is invoked that if as a condition to the making of a loan at an apparently permissible rate of interest, the lender requires the borrower to sell property to him at less than its value or to purchase property from him at an excessive price, the difference represents interest and will be taken into account in determining whether the transaction is usurious. That principle is firmly rooted and we are in accord with it, . . ." (*Oil City Motor Co.* v. *C.I.T. Corporation,* 76 F.2d 589, 591 (10th Cir., 1935).) (Emphasis supplied.)

The government attempts to avoid the impact of this well-established rule by stating that the price which respondents and others were required to pay for Class "C" stock was not excessive. This, of course, begs the precise question on which this case turns. We show below that Class "C" stock was worth far less than $100 per share. If that be true, payment of $100 per share for it was "excessive." In addition, the government seeks to distinguish the usury cases by implying that their application is limited to situations involving "corrupt" agreements or "devices." The suggestion that respondents here be required to show some "crooked scheme" in order to be entitled to claim an interest or business expense deduction for the excess of what they paid over the fair market value of the Class "C" stock is totally

without merit. It has never been held that the right to allocate price on the basis of actual facts is dependent upon a showing of fraud.

The government seeks to avoid the application of this principle by relying on several cases involving simultaneous loans and stock purchases from building and loan associations. (Govt. Br. pp. 39-41.) But these cases are not apposite because in none of them did the borrower contend that the building and loan association stock required to be purchased was not in fact worth what was paid for it.

Throughout its brief, the government makes arguments which completely ignore the dual nature of the transaction here involved. It contends, for example, that respondents are not entitled to a deduction merely because they may have paid more for an asset than it was worth and that the realization of loss must therefore await the disposition or complete worthlessness of the stock. The general rule which the government states is completely sound, but it has no application to the issue in this case. The question here, which the government constantly seeks to avoid, is not what result follows when a taxpayer, in a transaction involving only the acquisition of a single item of property, pays more for that item than it is worth. Of course, in such a situation the taxpayer must wait until the property is sold or disposed of before he can deduct the loss, if any, which he has suffered. The question here is, and always has been, whether respondents in the *dual* transaction here involved, pursuant to which they acquired *both* Class "C" stock *and* the use of money, are entitled to deduct that portion of the $100 per share purchase price purportedly paid for the Class "C" stock, which was in

substance and in fact paid not for the stock, but for the use of money.

Failure to focus on this issue caused the Eighth Circuit Court of Appeals in the *M.F.A. Central* case erroneously to reverse the district court decision in favor of the taxpayer cooperative, which was based on the ground that the $100 per share ostensibly paid for Class "C" stock was actually paid for the use of money since the Class "C" stock had no fair market value. The Court of Appeals approached the *M.F.A.* case as though M.F.A., in a transaction having no other facets or ramifications, had paid $100 per share for Class "C" stock and had then sought a deduction on the ground that the stock was not worth the price paid for it. If that had been the case (as it would have been if, for example, M.F.A. had purchased the stock from another cooperative which had nothing to sell but the stock itself), the Court's decision would clearly be correct. Under such circumstances, M.F.A. would be entitled to no deduction unless and until it disposed of the stock for less than the $100 per share paid for it. That would be true, irrespective of whether the Class "C" stock in the hands of M.F.A. was a capital asset, as the Eighth Circuit goes to great length to conclude, or a non-capital asset.

But obviously, the *M.F.A.* case did not (just as the case at bar does not) pose the issue which the Eighth Circuit decided. M.F.A. was not seeking to deduct, as interest or as a business expense, any amount which was in reality paid for Class "C" stock. It is implicit in M.F.A.'s argument, as it is in the argument of the taxpayers in this case, and in *Penn Yan Agway Cooperative, Inc.* v. *United States, supra,* that any portion of the $100 per share which could fairly

be held to have been paid for the Class "C" stock would not be deductible when paid; such amount would constitute the tax basis of the stock which would determine the profit or loss realized when the stock was disposed of. What all of these taxpayers have contended is that they should be entitled to deduct, either as interest or as a business expense, that portion of the price *purportedly* paid for this stock which was *in fact* paid, not for such stock, but rather solely for the use of money.

If the Eighth Circuit had recognized that the taxpayer was not seeking to take a loss on stock which it had purchased, but was merely seeking realistically to determine what portion of the $100 per share was paid for such stock, and what portion was paid for the use of money, and was claiming a deduction only for the latter portion, the Court could not have fallen into the error manifested by its opinion.

The only question in *M.F.A.* as to which there could be a reasonable difference of opinion is not a question of law, but solely a question of fact—i.e., what portion of the $100 per share was, in substance and in fact, paid for the stock and what portion was paid for the use of money? The Eighth Circuit did not believe that the record in the *M.F.A.* case justified the finding of the District Court that the Class "C" stock of the St. Louis Bank had *no* fair market value. While any precise determination of fair market value is difficult, it should be clear, for the reasons stated below with respect to the stock of the New Orleans Bank, that the Class "C" stock of the St. Louis Bank had a fair market value of no more than a small fraction of the $100 par value purchase price. Perhaps a small percentage of the $100 per share might realis-

tically be said to have been paid for the stock; but that would not justify the Court of Appeals in denying a deduction for that portion—clearly the major portion—of the $100 which was paid, not for the stock, but for the use of money. On the assumption that the stock had some small fair market value the appropriate action by the court of appeals would have been, not to reverse the district court as to the entire $100 per share, but rather to remand the case for a finding of the precise fair market value of the Class "C" stock on the dates it was issued. Accordingly, respondents submit that the Eighth Circuit initially erred by misunderstanding the issue before it and then compounded its error by failing to follow the proper procedural disposition of the case.

The government in its Supplemental Brief argues that *Commissioner v. Lincoln Savings and Loan Association*, No. 544, 1970 Term, 39 U.S.L.W. 4726, requires a decision for the government here. We submit that *Lincoln* is clearly distinguishable from the present case. In *Lincoln* this Court held that "additional premium" payments by a state-chartered savings and loan association to the Federal Savings and Loan Insurance Corporation (FSLIC), required to be made under Section 404(d) of the National Housing Act as prepayments with respect to future premiums, were capital expenditures and not insurance premiums currently deductible as ordinary and necessary business expenses under Section 162(a) of the Internal Revenue Code. It is true that both *Lincoln* and the present case involve the same *general* issue—i.e., whether a payment is a capital expenditure or a deductible expense. But here the similarity ends. The differences in the factual patterns of the two cases, referred to

in detail in respondents' brief, are numerous and significant. The fundamental difference between the two cases is that the issue on which this case turns, i.e., the proper allocation of a payment between two items, was not presented to or considered by this Court or either of the lower courts in *Lincoln*.

The payments at issue in *Lincoln* were credited to a "Secondary Reserve," and a separate account was maintained reflecting each contributing insured institution's share of such Reserve. The statute provided for the mandatory refund in cash of an insured institution's share of the Secondary Reserve upon termination of its insured status or when the FSLIC's "Primary Reserve" reached a stated level. It further provided for the mandatory use of an institution's share of the Secondary Reserve to pay the institution's basic insurance premiums when the aggregate of the Primary and Secondary Reserves reached a specified level. The FSLIC was required to, and did, credit to each institution's balance in the Secondary Reserve an amount computed at a rate equal to the FSLIC's return on specified investments. It was found that the Section 404(d) payments created a separate and distinct income-producing asset, i.e., the payor's share in the Secondary Reserve, and accordingly did not give rise to a tax deduction.

Perhaps because of the income-producing aspect of the Secondary Reserve and its other characteristics which differ markedly from those of Class "C" stock, the taxpayer in *Lincoln* made no allegation and offered no proof that its investment in the Secondary Reserve had a fair market value less than the amount paid by the taxpayer. That taxpayer took the position that it was entitled to deduct the entire amount

paid without regard to the value of any asset created by the payment. Consequently, no court involved in the *Lincoln* litigation even considered the effect of a possible discrepancy between the amount paid by the taxpayer and the value of the asset acquired. In the present case, on the other hand, the existence of such a discrepancy is the heart of the taxpayer's case. Here the taxpayer seeks to deduct only that portion of its payment which, because it exceeds the fair market value of Class "C" stock, was in reality not paid for that asset, but rather for the use of money.

B. The Fair Market Value of the Class "C" Stock of the New Orleans Bank for Cooperatives Was No More Than a Small Fraction of the Par Value ($100 Per Share) Which Respondents Were Required To Pay for Such Stock.

The characteristics of the Class "C" stock of the New Orleans Bank for Cooperatives purchased by respondents during the years in question lead inevitably to the conclusion that such stock could not have a fair market value anywhere near its $100 per share par value. That stock paid no dividends and had no growth potential. It was redeemable at par, but only after the prior retirement of all Class "A" and Class "B" stock and previously issued Class "C" shares. Even then, redemption was subject to the discretion of the Board of Directors of the Bank. At the time of acquisition, the facts indicated that the Class "C" stock in question would be retired, if at all, only at some indefinite, but distant future date.[4]

[4] The government goes outside of the record (Govt. Br. p. 7) to refer to Farm Credit Administration records which purportedly show a fourteen year redemption period for the first series of Class "C" stock issued by the New Orleans Bank. Of course, the valuation issue here involved is the value of Class "C" stock *at*

Transferability of the shares was also restricted in that they could be sold or transferred only to another qualified farmers' cooperative with the prior authorization of the Bank's Board of Directors and the approval of the Farm Credit Administration. Finally, the Class "C" stock here involved carried no voting rights, since each shareholder was limited to one vote and this vote had been acquired in earlier years when respondents had purchased the initial qualifying share which was a prerequisite to borrowing from the Bank. No one in his right mind would have voluntarily paid more than a small fraction of par for additional shares of Class "C" stock.

The district court found that such stock had only a nominal value, not in excess of $1 per share. We believe that the evidence supports that finding. If this Court should disagree, it should, we respectfully submit, remand the case for a new determination of fair market value. It would not be proper to reverse, as the Eighth Circuit did in *M.F.A. Central,* because whether one concludes that $1 or $5 or $10 per share is the correct fair market value of the Class "C" stock here involved, it cannot be gainsaid that the fair mar-

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the time it was acquired by respondents. This value must be based upon facts known or knowable at that time. When the Class "C" stock at issue was acquired, respondents had no way of knowing that redemption might be made within fourteen years. Indeed, the government's own expert witness assumed, on the basis of information available as of the end of the fiscal year 1958, the first year involved in this case, that it would take 28 years to redeem Class "C" stock issued in 1958. R. 218, 296-7. *Cf. Penn Yan Agway Cooperative, Inc.* v. *United States,* 417 F.2d 1372 (Ct. Cl. 1969), in which an estimate of a thirty-year redemption period for Class "C" stock of the Springfield Bank for Cooperatives issued in 1959 was accepted by the court in the light of facts known to the taxpayer at the end of that fiscal year.

ket value of such stock was far below the $100 per share par value which respondents were required to pay.[5]

In its brief to this Court, the government goes to great lengths in an attempt to show that the Class "C" stock was an asset having a value equivalent to the price which respondents were required to pay for such stock under their loan agreements. However, analysis of the government's contentions on this issue reveals that the characteristics emphasized in the brief have no bearing on the actual fair market value of the stock in question nor on the proper characterization of amounts purportedly paid by respondents for such stock.

For example, the government argues that the Class "C" stock has certain "intrinsic" value. In support of this contention, it cites the various financial services provided by the banks to member cooperatives and emphasizes the ultimate vesting of bank ownership and control in borrowing cooperatives as a result of the retirement of government capital (Class "A" stock) with the proceeds of required Class "C" stock purchases. Without belaboring the point that Federal tax laws are not concerned with "intrinsic" value but only with fair market value, it is clear that the factors cited by the government are irrelevant to the issue of stock value and to the proper characterization of the payments made by respondents. The right to receive financial services provided by the Banks for Cooperatives is obtained upon purchase of the initial

[5] The government's own expert witness testified on direct examination that the stock in question had a fair market value ranging from $3.42 to $38.65 per share, depending upon the year of its issuance. (R. 294.)

qualifying share of Class "C" stock. Subsequent distinctions in the level of sophistication of those services as between member cooperatives depend, not upon the amount of Class "C" stock which a borrower owns, but upon the amount of business done with the bank —i.e., the amount of money borrowed. It is obvious that the financial services do not enhance the value of the stock. Respondents would be entitled to identical services even if they sold or otherwise disposed of every share of Class "C" stock which they had acquired (over and above the single qualifying share which they were required to own).

In making its determination that Class "C" stock had only nominal value, the district court correctly concluded that this stock earns no return; it pays no dividend and is entitled to no more than par value upon redemption. Nevertheless, the government would have this Court believe that Class "C" stock "in substance earns a return" on the theory that it entitles its owners to receive patronage refunds in the form of Class "C" stock. (Govt. Br. pp. 23-28; Supp. Br. p. 3.) In essence, the government argues that the receipt of patronage refunds by a cooperative in any given year is somehow dependent upon the amount of Class "C" stock required to be purchased by the cooperative during that year and that such Class "C" stock is therefore entitled to a share of the Bank's profits for that year. This argument, if not a deliberate attempt to mislead the Court, reveals a complete lack of understanding of the patronage refund system of the Banks for Cooperatives.

A cooperative borrower's share of the patronage refunds paid by a Bank in any given year is computed by comparing the amount of interest paid by that co-

operative to the total interest payments made by all borrowing cooperatives during the year. (12 U.S.C. § 1134*l*(b), quoted at Govt. Br. p. 52.) Patronage refunds are refunds of the interest paid by the customers or patrons of the Bank. As the following discussion makes obvious, there can be no serious suggestion that patronage refunds are issued with respect to Class "C" stock purchased during the year. It is not by making required Class "C" stock purchases that a cooperative becomes entitled to receive patronage refunds, but by the act of borrowing money and paying interest to the Bank.

This becomes crystal clear when one realizes the undeniable fact that *the amount of patronage refunds to which a cooperative is entitled in any given year would not be affected in any way if the cooperative were to transfer to another cooperative, pursuant to the limited permission granted by the statute, all or any part of the transferror's Class "C" stock* (over and above its single qualifying share which entitles it to do business with the Bank) *whether such stock had been purchased or acquired as a patronage refund or as a distribution of allocated surplus in that year or any other year.* The patronage refund would still be made on the basis of the interest paid by the transferor cooperative. The amount of Class "C" stock purchased or otherwise acquired or held during the year would have no bearing whatever on the patronage refunds. Moreover, the transferee cooperative in such a situation would not be entitled to any increase in patronage refunds as a result of its acquisition of additional Class "C" stock. Finally, an increase or decrease in the amount of required Class "C" stock purchases, pursuant to the statutory pro-

vision authorizing the Banks to set the amount at from 10% to 25% of quarterly interest payments, would not result in any corresponding increase or decrease in patronage refunds. Accordingly, it is simply untrue to say that Class "C" stock earns a return in the form of patronage refunds.[6]

Furthermore, the proper tax treatment of patronage refunds in the form of Class "C" stock illustrates the fallacy in the government's effort to ascribe a substantial fair market value to purchased Class "C" stock. When Class "C" stock of a Bank (or any stock of any cooperative organization) is issued as a patronage refund, the amount to be reflected in the income of the patron receiving such stock is the "fair market value," if any, of such stock. Regs. § 1.61-5(b)(1)(iv).[7] Any argument by the government that the Class "C" stock issued by the New Orleans Bank for Cooperatives has more than nominal value is clearly inconsistent with its failure to appeal from the decision of the district court in this case that Class "C" stock received as patronage refunds must be included in respondents' income only to the extent of $1 per

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[6] After making its tortured argument, the government then reverses itself and concedes that Class "C" stock does not produce any investment return, when it states at page 33 of its brief:

> "The primary difference between the common stock of a cooperative and that of an ordinary corporation is that common stock ownership in a cooperative does not, in and of itself, entitle one to a share in the distribution of each year's profits."

[7] This is the rule with respect to years as to which Subchapter T of the Internal Revenue Code does not apply. Subchapter T did not apply to the Banks during the years here involved.

share.[8] By its inaction, the government has in effect admitted that the fair market value of Class "C" stock is no more than $1 per share. Since the Class "C" stock issued as patronage refunds and the Class "C" stock required to be purchased pursuant to the loan agreements are identical, it clearly follows that the same standard should be applied in assessing the value of this stock, regardless of how it is acquired. If receipt of a share of Class "C" stock as a patronage refund constitutes a $1 refund of the amount paid by respondents as interest, surely the same result must follow when a share of identical stock is received for a payment which is required in order to permit the payor to borrow money. If this stock is really worth its par value, why has the government abandoned any effort to require respondents and other taxpayers to include the full par value of patronage refunds in their respective taxable incomes for the years in question?

The government seeks to explain away this glaring inconsistency by suggesting that there is some difference between accrual basis taxpayers, such as respondents, and cash basis taxpayers in the treatment of patronage refunds. (Govt. Br. p. 26, fn. 22.) The attempted distinction is specious. The governing Treasury Regulation, cited above, taxes the fair market value of stock received as a patronage refund without

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8 Respondents had reflected in income the fair market value of $1 per share for Class "C" stock received as patronage refunds during the years in question, in the form of a reduction of interest expense. No part of the remaining $99 par value of such stock was reported as an income or as a reduction of interest expense. The government initially contended that respondents should have reflected in their taxable income for those years the entire par value of such patronage refund stock.

regard to whether the recipient taxpayer reports on the cash or the accrual method of accounting. Indeed, no issue of accrual could possibly be involved since there is no promise to pay and consequently no obligation on the part of the Bank. *Any* taxpayer receiving stock as a patronage refund is treated as receiving the equivalent of cash to the extent the stock has fair market value. The government cannot avoid the inconsistency between its failure to appeal the finding that Class "C" stock received as a patronage refund was worth only $1 per share and its present contention that such stock is worth its full par value of $100 per share.

In summary, no argument has been made which would justify overruling the finding of the court below that the Class "C" stock in question had only a nominal value. Even if this Court were to conclude that the district court's valuation of $1 per share is not supported by the evidence, the proper procedure would be to remand for an appropriate determination on this issue, recognizing that the excess of purchase price over whatever is determined to be the fair market value of the stock will in substance represent a payment, not for stock, but for the use of money.

CONCLUSION

For the foregoing reasons, the decision of the court below should be affirmed.

Respectfully submitted,

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